No. 288

In the Supreme Court of the United States

October Term, 1957

JOHN P. DALEY, MINERVA B. DALEY, MORRIS DALEY, ZELMA B. DALEY, WILLIAM RADTKE, CLARA RADTKE AND HOMER BOSSE, TRUSTEE OF THE ESTATES OF MORRIS K. DALEY, ALICE M. DALEY, SUSAN R. DALEY, JAMES D. DALEY, KATHRYN F. DALEY AND PETER D. DALEY, PETITIONERS

v.

UNITED STATES OF AMERICA

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

BRIEF FOR THE UNITED STATES IN OPPOSITION

J. LEE RANKIN,
Solicitor General,

CHARLES K. RICE,
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BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The decision of the District Court (R. 102-112) is reported at 139 F. Supp. 376. The opinion of the Court of Appeals (Pet. 1a-18a) is reported at 243 F. 2d 466.

JURISDICTION

The judgment of the Court of Appeals was entered on April 18, 1957. (R. 275:) The petition for a writ of certiorari was filed July 17, 1957. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254(1).

QUESTIONS PRESENTED

1. Whether the Court of Appeals properly held that the District Court was not clearly erroneous in finding that a joint venture intentionally elected to compute and report the income from a construction contract by means of the accrual method of accounting rather than the completed contract method.

2. Whether the Court of Appeals erred in holding that taxpayers could not correct the joint venture's accrual computation in this action, inasmuch as the taxpayers' claims for refund and complaint were based on a different ground, and were insufficient to raise the question of adjustment of the accrual computation.

3. Whether the Court of Appeals abused its discretion in refusing to remand the cause for a finding with respect to the question of whether the Commissioner, by his conduct, waived the defects in the claims, where the question was raised for the first time on appeal and could have been litigated during the trial.

4. Whether taxpayers may raise the question of whether defects were cured or waived by a supplemental stipulation for refund when that question is raised for the first time in this Court.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Sections 41, 42(a), 43 and 3772(a) of the Internal Revenue Code of 1939, and of Sections 29.42-4 and 29.322-3 of Treasury Regulations 111 are set forth in the Appendix, *infra*, pp. 14-17.

STATEMENT

The facts as found by the District Court (R. 107-110) and as stipulated (R. 16-24) may be summarized as follows:

John P. Daley and Morris Daley were engaged in a general contracting business as copartners, operating under the firm name of Daley Brothers. On June 30, 1942, John P. Daley and Morris Daley, as general partners, formed a limited partnership with Homer Bosse, trustee for the benefit of the Daley's children, as limited partner, and the business which previously had operated under the firm name of Daley Brothers was continued as Daley Brothers, Limited. On July 8, 1942, the limited partnership entered into a Government construction contract. Upon the securing of this contract, Daley Brothers, Limited, entered into a joint venture with William Radtke, which was called the Daley Brothers Delta War Venture (hereinafter called the joint venture), for the purpose of performing the contract. (R. 18-19, 108.)[1]

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[1] Petitioners in this case are John P. and Minerva B. Daley, husband and wife; Morris and Zelma B. Daley, husband and wife; William and Clara Radtke, husband and wife, and Homer Bosse, trustee of the estates of Morris K.,

The contract called for a lump sum consideration of $2,834,212.51, and was to be completed on or before September 6, 1942. (R. 19.) A series of supplemental agreements increased the consideration for the contract to its final amount of $3,653,259.12, and extended the date of completion to February 16, 1943. The contract was in fact completed and the work accepted by the Government as of this date. (R. 19-21.)

The joint venture filed a separate partnership income tax return for the period June 1, 1942, to December 31, 1942, reporting the full contract price ($3,655,672.28) as gross income and distributing net income in the amount of $206,250.44 between Daley Brothers, Limited, and William Radtke. (R. 22; Ex. 18, R. 86-87.)

In 1947, the joint venture filed amended partnership income tax returns for 1942 and 1943, in which it reported no income from the contract in 1942 and the entire receipts from the contract in 1943. Along with these amended partnership returns, taxpayers filed claims for refund and amended individual tax returns reflecting the changes made by the partnership returns. (R. 109-110.) The claims for refund asserted that the amended income tax returns filed in 1947 were consistent with the accounting procedure followed by the Daley Brothers partnership

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Alice M., Susan R., James D., Kathryn F. and Peter D. Daley, all of whom are joined as a result of filing individual income tax returns reflecting shares of income from the Delta War Venture. (R. 17-18, 22-24.)

during 1943 and prior years,[2] and were to correct the original returns which erroneously reported the income from the contract in 1942, while the contract was completed in 1943. (R. 94, 99, 109-110.) On rejection of these claims (R. 96, 100), taxpayers filed a complaint in the District Court, which alleged that the accountant for the joint venture acted under the mistaken assumption that the monies received under the contract were income for the year 1942, and that such monies were not income until the next year, when the contract was completed and accepted. The complaint further alleged that, at the end of the calendar year 1942, an income tax return was made for the joint venture, notwithstanding the fact that the contract was not completed and accepted before December 31, 1942, and that the tax return for 1942 was erroneously made and reported on the mistaken theory that the income was earned in 1942. (R. 10-11.)

The Government rejected the claims and opposed the action on the ground that the joint venture did not err in applying the completed contract method, but in fact had adopted the accrual method. (R. 105.) The District Court found that, at the time the 1942 return was filed, taxpayers and their accountant[3] knew that the contract was not completed until 1943, and that the reporting of all of the re-

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[2] The partnership in prior years had reported income from other contracts on the completed contract basis. (R. 18.)

[3] The District Court observed (R. 106) that the testimony of the accountant was not credible.

ceipts from the contract was not the result of a mistaken belief on the part of anyone that the contract was completed in the earlier year. The court also found that the taxpayers, on the partnership return and in a form submitted to another governmental agency, stated that the basis used in reporting revenue from the contract was the accrual basis. Accordingly, the District Court held that the accrual method of accounting was elected by the joint venture. (R. 109, 110.)[4] In addition, although the point was not in issue, the court further noted that it did appear that certain errors existed in taxpayers' accrual computation, but held that, since taxpayers' refund claims and complaint sought refunds solely on the ground that all of the contract receipts had been erroneously reported as income in 1942 as a result of a mistaken application of the completed contract method of accounting, any error resulting from a mistaken application of the accrual method could not be reached or corrected in this action. (R. 104-105, 106, 111.)

The Court of Appeals affirmed the finding of the District Court that taxpayers intentionally reported the income from the contract in their 1942 tax returns on the accrual basis. (Pet. 13a.) The court, agreeing with the District Court, also held that the refund claims, amended returns, and complaint did not set forth the correction of taxpayers' computa-

[4] The court further observed (R. 106) that taxpayers' financial status at the end of 1943 made it advantageous *ex post facto* to shift the contract income to 1943.

tion of their income on the accrual basis as an alternative ground for recovery, and refused to remand the case for a determination of the amount of refund due because of asserted errors in taxpayers' accrual computation." (Pet. 13a-15a.) The Court of Appeals further held that it would not remand the case to the District Court to consider taxpayers' assertion that the Commissioner, by his conduct, waived any defect in the claims inasmuch as such contention was urged for the first time on appeal and could have been litigated in the trial court. (Pet. 16a.)

ARGUMENT

1. Sections 41, 42, and 43 of the Internal Revenue Code of 1939 (Appendix, *infra*, pp. 14-15) set forth the general rules with respect to the permissible methods of accounting for income tax purposes, and specifically recognize and authorize the cash basis and accrual basis as the two principal methods of recording and reporting items of income and expense. In addition to these methods, Section 29.42-4 of Treasury Regulations 111 (Appendix, *infra*, pp. 15-16) allows persons whose income is derived in whole or in part from "long-term" construction contracts to elect to report the gross income from such contracts upon the completed contract method. Under this method, the gross income from the contract is reported in the period in which the contract is finally completed and accepted, and all expenditures allocable to the contract are deducted in the same period.

It is clear that the first question presented (i. e., whether taxpayers elected to compute and report the income from a construction contract by means of the accrual method or by the completed contract method) is entirely factual. There was substantial evidence upon which the District Court based its finding and conclusion (R. 110, 111) that taxpayers elected to report on the accrual method, and the Court of Appeals, in a careful review of this evidence, affirmed this finding. (Pet. 5a-13a.) The issue clearly presents no question for review by this Court. *Comstock* v. *Group of Investors*, 335 U. S. 211, 214.

2. Taxpayers, in the alternative, and for the first time, contended in the Court of Appeals that, since they were held to have reported their income on the accrual basis, they should be permitted to correct certain errors in their accrual computation, and that the case should be remanded to determine the amount of refund due them on this ground. (Pet. 13a.)

The District Court had stated (R. 106, 111) that it appeared that some of the income from the contract in question in fact did not accrue until 1943 and was improperly included in taxpayers' 1942 returns. But the court noted that this error could not be reached or corrected in this action since the taxpayers did not present the correction of its accrual computation as a basis for refund in their refund claims or in their complaint. Taxpayers, instead, sought refunds solely on the ground that they elected to report on the completed contract method, and that all the income should be shifted to 1943 since the contract was not completed until 1943. The correctness of the accrual computations was not placed in issue at any time prior to, during, or after the trial, and the District Court's observations with respect thereto are merely dicta.

It is well-settled that a suit for refund of taxes must be based on a claim for refund previously filed with the Commissioner and that the claim must set forth in detail each ground upon which a refund is claimed, with sufficient facts to apprise the Commissioner of the exact basis thereof. Recovery can only be had on grounds presented to, or considered by, the Commissioner. Section 3772(a)(1) of the Internal Revenue Code of 1939 (Appendix, *infra*, p. 15); Section 29.322-3 of Treasury Regulations 111 (Appendix, *infra*, pp. 16-17); *Angelus Milling Co.* v. *Commissioner*, 325 U. S. 293, 297-298; *Real Estate Title Co.* v. *United States*, 309 U. S. 13, 17-18; *United States* v. *Memphis Cotton Oil Co.*, 288 U. S. 62, 69-72. Here, as both the District Court (R. 106, 111) and the Court of Appeals (Pet. 13a-15a) found, the refund claims and the taxpayers' complaint[6] were based on the ground that taxpayers had in fact elected to use the completed contract method, had erroneously reported the contract receipts in 1942, and desired a refund based upon shifting all of the income to 1943. There was nothing presented to apprise the Commissioner that taxpayers sought a refund on the basis of an adjustment of assertedly erroneous accrual computations. The question of the basis of the taxpayers' claim is factual, and the concurrent findings of the two courts below should be considered final. *Comstock* v. *Group of Investors*, *supra*.

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[6] As well as the amended tax returns filed with the claims (Pet. 14a), the offers of proof at the trial, and the briefs filed in the trial court.

3. The question of whether the Commissioner by his conduct or knowledge waived the insufficiency of the claims likewise presents no question for review by this Court. The Commissioner, prior to the expiration of the statute of limitations for the filing of claims, can waive a defect in a claim for refund. See *United States* v. *Garbutt Oil Co.*, 302 U. S. 528, 533; *Tucker* v. *Alexander*, 275 U. S. 228. The Court of Appeals, however, properly did not pass on the merits of taxpayers' assertion that the Commissioner, by his conduct and knowledge, waived the defect in the claims,[7] and the merits of the contention should not be considered by this Court. *McCullough* v. *Kammerer Corp.*, 323 U. S. 327. The Court of Appeals also properly acted within its discretion in refusing to remand the cause to the trial court to enable taxpayers to offer evidence of a waiver, since the particular issue could have been litigated at the trial. Cf. *Bankers Pocahontas Coal Co.* v. *Burnet*, 287 U. S. 308, 313; *Pennsylvania Railroad Co.* v.

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[7] Because taxpayers raised the question of waiver for the first time on appeal, the record presents no evidence with respect to the Commissioner's knowledge or conduct prior to the trial. The record clearly shows that the only issue litigated during the trial was whether taxpayers elected to use the completed contract basis and, if so, when the contract was completed. Furthermore, there was no waiver of the defects in the claim; the claims, and the amended returns attached thereto (as well as the complaint and conduct of the trial), specifically directed the Commissioner's attention to this sole issue and the Commissioner was entitled to take it at face value and was not required to examine another ground at odds thereto. *United States* v. *Garbutt Oil Co.*, *supra*, pp. 532-533.

Public Utilities Commission of Ohio, 298 U.S. 170, 177.

4. With respect to the question of whether a supplemental stipulation (R. 101) cured or waived the defect in the claims, this contention was not presented to the District Court or the Court of Appeals, but is, instead, first submitted to this Court and should not be considered. *McCullough* v. *Kammerer Corp.*, *supra*.

5. The decision below is not in conflict with that of any other court of appeals. Furthermore, contrary to taxpayers' bald assertion (Pet. 5-6) (which does not specify a single point of conflict), the decision does not conflict with any decision of this Court. None of the cases cited by taxpayer (Pet. 5-6) involved the factual questions presented here of whether a taxpayer elected to report income on the accrual or completed contract basis, or whether a particular refund claim supports a refund based on the adjustment of an accrual computation.[*] Sim-

[*] *Helvering* v. *Enright*, 312 U. S. 636, involves the question of whether a decedent's gross income must include his share of profits earned, but not yet received, by a partnership of which he was a member, where both the decedent and the partnership were on the cash basis. *Spring City Co.* v. *Commissioner*, 292 U. S. 182, involves the question of whether a debt-owing taxpayer for goods sold must be included in income in the year of sale even if the debt became partially worthless during that year. Both cases merely set forth the principle that, under the accrual method, it is the right to receive income, and not the actual receipt thereof, which determines the period in which income is reported; the Court of Appeals herein specifically recognized this principle (Pet. 17a), but held that taxpayers were not

ilarly, the cases cited with respect to the issue of whether the defects in the claims were cured or waived present no conflict.[9] In addition, contrary to

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entitled to correct an assertedly improper accrual of income because their refund claims did not sufficiently set forth such grounds. (Pet. 13a-15a). *Aluminum Castings Co.* v. *Routzahn*, 282 U. S. 92, held that a taxpayer's declaration on its return of whether it was on the cash or accrual basis was not conclusive; the courts below did not consider it so, either, but merely viewed it as a relevant circumstance to be considered in determining taxpayers' intent to elect one method or another. (Pet. 10a-11a). *Weiss* v. *Wiener*, 279 U.S. 333, involves a depreciation deduction by a lessee in a long-term lease, and *Old Colony Railroad Co.* v. *Commissioner*, 284 U. S. 552, involves the treatment of premiums received on bonds sold prior to 1913; neither case is at all in point here.

[9] In *Tucker* v. *Alexander*, *supra*, the objection that a ground in a refund claim was not sufficiently specified was held to be waived by a stipulation; in addition, during the trial, the only issue litigated was the ground which assertedly was not sufficiently specified. Here, there was no similar stipulation which would constitute a waiver. Furthermore, the ground which was not specified in the claims (the correction of the accrual computation) was not litigated at the trial, but was first presented upon appeal.

United States v. *Garbutt Oil Co.*, *supra*, involves an attempt to *amend* a claim and is not a question involving *waiver*; the case holds that the amendment (which was directly at odds with the original claim) amounted to a new claim which was not filed in time. The case also repeats the rule that the Commissioner was without power to waive the statute of limitations. See *United States* v. *Andrews*, 302 U. S. 517. Instead of being of assistance to taxpayers, these decisions preclude taxpayers in the instant case from seeking to amend their original claims to claim an adjustment of the accrual computation (a new claim) or to show acts of waiver after March 15, 1947, the date the statute of limitations expired here.

taxpayers' alternative assertion (Pet. 6), it is clear that the case presents no important question of federal law, but instead turns on its own particular facts.

CONCLUSION

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

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LEE A. JACKSON,
SHELDON I. FINK,
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AUGUST, 1957.

APPENDIX

Internal Revenue Code of 1939:

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. * * *

(26 U. S. C. 1952 ed., Sec. 41.)

SEC. 42 [as amended by Sec. 114 of the Revenue Act of 1941, c. 412, 55 Stat. 687]. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

(a) *General Rule.*—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *

* * * *

(26 U. S. C. 1952 ed., Sec. 42.)

SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits (other than the corporation dividends paid credit provided in section 27) provided for in this chapter shall be taken for the taxable year in which "paid or accrued" or "paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to

clearly reflect the income the deductions or credits should be taken as of a different period. * * *

(26 U.S.C. 1952 ed., Sec. 43.)

SEC. 3772. SUITS FOR REFUND.

(a) *Limitations.*—

(1) *Claim.*—No suit or proceeding shall be maintained in any court for the recovery of any internal revenue tax alleged to have been erroneously or illegally assessed or collected, or of any penalty claimed to have been collected without authority, or of any sum alleged to have been excessive or in any manner wrongfully collected until a claim for refund or credit has been duly filed with the Commissioner according to the provisions of law in that regard, and the regulations of the Secretary established in pursuance thereof:

* * * *

(26 U. S. C. 1952 ed., Sec. 3772.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

SEC. 29.42-4. *Long-Term Contracts.*—Income from long-term contracts is taxable for the period in which the income is determined, such determination depending upon the nature and terms of the particular contract. As used in this section the term "long-term contracts" means building, installation, or construction contracts covering a period in excess of one year from the date of execution of the contract to the date on which the contract is finally completed and accepted. Persons whose income is derived in whole or in part from such contracts may, as to such income, prepare their returns upon either of the following bases:

(a) Gross income derived from such contracts may be reported upon the basis of percentage of completion. In such case

there should accompany the return certificates of architects or engineers showing the percentage of completion during the taxable year of the entire work to be performed under the contract. There should be deducted from such gross income all expenditures made during the taxable year on account of the contract, account being taken of the material and supplies on hand at the beginning and end of the taxable period for use in connection with the work under the contract but not yet so applied.

(b) Gross income may be reported for the taxable year in which the contract is finally completed and accepted if the taxpayer elects as a consistent practice so to treat such income, provided such method clearly reflects the net income. If this method is adopted there should be deducted from gross income all expenditures during the life of the contract which are properly allocated thereto, taking into consideration any material and supplies charged to the work under the contract but remaining on hand at the time of completion.

A taxpayer may change his method of accounting to accord with paragraph (a) or (b) of this section only after permission is secured from the Commissioner as provided in section 29.41-2.

SEC. 29.322-3. *Claims For Refund By Taxpayers.*—Claims by the taxpayer for the refunding of taxes, interest, penalties, and additions to tax erroneously or illegally collected shall be made on Form 843, and should be filed with the collector of internal revenue. A separate claim on such form shall be made for each taxable year or period.

The claim must set forth in detail and under oath each ground upon which a refund is claimed, and facts sufficient to apprise the Commissioner

of the exact basis thereof. No refund or credit will be allowed after the expiration of the statutory period of limitation applicable to the filing of a claim therefor except upon one or more of the grounds set forth in a claim filed prior to the expiration of such period. A claim which does not comply with this paragraph will not be considered for any purpose as a claim for refund. * * *

* * * * *

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APPENDIX

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 15,181

April 18, 1957

JOHN P. DALEY, MINERVA B. DALEY, MORRIS DALEY, ZELMA B. DALEY, WILLIAM RADTKE, CLARA RADTKE, and HOMER BOSSE, Trustee of the Estate of Morris K. Daley, Alice M. Daley, Susan R. Daley, James D. Daley, Kathryn F. Daley, and Peter D. Daley, *Appellants*,

v.

UNITED STATES OF AMERICA, *Appellee*.

Appeal from the United States District Court for the Northern District of California, Southern Division

Before: ORR, FEE, and CHAMBERS, Circuit Judges

ORR, Circuit Judge:

In July, 1942, Daley Brothers, Ltd., were awarded a contract by United States of America to construct a relocation center in Delta, Utah. Daley Brothers, Ltd., consisted of John P. Daley, Morris Daley, and Homer Bosse, Trustee of six trusts formerly created for the benefit of the Daley children. Daley Brothers, Ltd., formed a joint venture, hereafter the Venture, with William Radtke, to undertake performance of the contract. Appellants here are John Daley, Morris Daley, Bosse, and Radtke, together with their respective spouses.

The contract was to be completed on or before September 6, 1942. Several agreements supplmental to the original contract were entered into which extended the completion date to February 16, 1943, at which time the work done under the contract was accepted as finished and satisfactory by the Government.

The original contract price was $2,834,212.51; supplemental agreements increased the price to $3,653,259.12. Progress payments were made beginning with the construction period ending August 26, 1942.[1] By the end of 1942 nine progress payments had been made, amounting to $3,180,536.97, about 90% of the total contract price.

The Venture showed gross receipts of $3,655,672.28 upon its partnership return of income for 1942, indicating that the total contract price had been accrued on the books. The Venture's return indicated the partners' shares as going to Daley Brothers and William Radtke. On the

[1] Article 16 of the contract read:

"Payments to contractors—(a) Unless otherwise provided in the specifications, partial payments will be made as the work progresses at the end of each calendar month, or as soon thereafter as practicable, on estimates made and approved by the contracting officer. In preparing estimates the material delivered on the site and preparatory work done may be taken into consideration.

"(b) In making such partial payments there shall be retained 10 per cent on the estimated amount until final completion and acceptance of all work covered by the contract: Provided, however, That the contracting officer, at any time after 50 per cent of the work has been completed, if he finds that satisfactory progress is being made, may make any of the remaining partial payments in full: And provided further, That on completion and acceptance of each separate building, vessel, public work, or other division of the contract, payment may be made in full, including retained percentages thereon, less authorized deductions.

"(c) All material and work covered by partial payments made shall thereupon become the sole property of the Government. . . .

"(d) Upon completion and acceptance of all work required hereunder, the amount due the contractor under this contract will be paid upon the presentation of a properly executed and duly certified voucher therefor, after the contractor shall have furnished the Government with a release, if required, of all claims against the Government arising under and by virtue of this contract, other than such claims, if any, as may be specifically excepted by the contractor from the operation of the release in stated amounts to be set forth therein."

fourth page of said return, the following appeared: "4. Check whether this return was prepared on the cash [ ] or accrual [x] basis." The Venture filed no return of income for 1943.

John P. Daley, Morris Daley, William Radtke, together with their spouses, and Homer Bosse as trustee, filed individual income tax returns for 1942 based on the 1942 Venture return.

In 1947 the Venture filed an amended partnership income tax return for 1942 and an amended return for 1943. The amended returns were accompanied by refund claims by the distributees of the Venture's net income. The Venture's amended 1942 return reported no gross receipts, profit, or loss from the Delta contract, but showed "advances" of $3,180,536.97. This was the sum of actual net progress payments received by the Venture as of December 31, 1942. The Venture's amended 1943 return showed gross receipts of $3,620,546.28, indicating the Delta contract was reported as being finished.

The identical refund claims of the taxpayers stated their claims should be allowed for the following reasons:

> "The change in the amended partnership income tax returns is for the reason that erroneous returns were filed for the years 1942 and 1943. The amended returns are consistent with the accounting procedure which was followed by Daley Brothers prior to 1942. The amended returns are to correct the Delta, Utah, contract which was completed on September 15, 1943, and erroneously included in income for the year 1942. The claim reflects the correct tax liability in accordance with sec. 6 of the current tax payment act of 1943, Public No. 68—78th Congress. Included in the correction is the amount of renegotiation refund which was erroneously deducted from income in the 1942 return. It is respectfully requested that refund in

the amount set forth in the claim and as also shown on the amended individual income tax return for 1943 be refunded."

Subsequent amended refund claims by John and Morris Daley in 1951 concerned a revision of income to the trusts created for their children, and stated almost verbatim the basis for refund in the original claims.

Each claim for refund was denied by the Commissioner of Internal Revenue.

The trial court found that the Venture was bound by its intentionally reporting 1942 income from the Delta contract on the accrual basis of accounting, and rejected the taxpayers' contention that the 1942 Venture return was on the completed contract basis of accounting, mistakenly applied.

The trial court did find, however, that under the accrual system, some of the Delta contract income did not in fact accrue until 1943, and therefore was improperly reported as 1942 income; but denied recovery of overpayment because the taxpayers failed to include the improper accrual in the refund claims as a ground for relief.

The main issues for solution are: (1) Whether the trial court's finding that the Venture elected to report 1942 income from the Delta contract on the accrual basis of accounting is supported by substantial evidence and therefore not clearly erroneous; (2) In the event we determine that the trial court's finding that the Venture elected to report on the accrual basis should be affirmed, then are the taxpayers entitled to recover the improper 1942 accruals in this action; and (3) Whether the accrual basis of accounting does not clearly reflect income from the Delta contract, so that the taxpayers are not bound by its election, and could amend to the completed contract basis of accounting for 1942 and 1943.

The District Court found:

> "The reporting by Daley Brothers Delta War Venture of all of the receipts from the War Department Contract as income on the 1942 return was not the result of a mistaken belief on the part of anyone that the contract was completed in 1942. At the time the return was filed the plaintiffs and their accountant knew the contract was not completed until 1943. All of the income from the contract was intentionally reported as accruing during the year 1942 although a portion of the income from that contract did, in fact, accrue in 1943."

and concluded:

> "That Daley Brothers Delta War Venture elected to report the income from the War Department contract for the year 1942 on the accrual basis of accounting."

The trial court further found (1) that the contract was not in fact completed as of December 31, 1942, and that this fact was obvious to everyone concerned; it discredited the testimony of the Venture's accountant to the effect that he prepared the return in the belief that the Delta contract had been completed in 1942; (2) that John P. Daley, the manager of the Venture, reported to the Army Engineers that the basis used in reporting revenue from the contract for income tax purposes was the accrual method, and not the completed contract method; and (3) that on the fourth page of the Venture's 1942 income tax return, the "accrual" box is marked for the accounting method employed in preparing the return.

We first examine the evidence upon which the trial court based its finding that the Venture intentionally elected to report income from the Delta contract on the accrual basis.

Appellants submit that the fact that all parties knew the contract was not completed on December 31, 1942, bears no relation to the question of whether the accrual method was used, and therefore cannot be said to support the finding that the completed contract basis was not used. Appellants urge that the fundamental feature of the completed contract method is the closing out of all of the receipts and expenses of a contract in one accounting period so as to reflect the net income from the contract; and that the Venture followed this method, but mistakenly used December 31, 1942, as the end of the period.

To evaluate properly appellants' contentions we must examine the concepts of the completed contract accounting method. In doing so, we keep in mind that the Venture had been organized for the sole purpose of executing the Delta contract, and therefore there are no considerations of multi-contract construction accounting involved.[2]

The crux of the completed contract method is the adjustment of the normal annual accounting period to coincide with the term of the construction contract, so that the total cost and the total revenue of the single contract are matched in a single accounting period. The annual accounting concept is rejected in favor of a period (necessarily longer than a year) equalling the time needed to complete fully the particular project.

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[2] A preliminary issue considered by the District Court, but not in issue on appeal, was whether the Venture was a new tax entity. It was stipulated that Daley Brothers, a partnership consisting of John and Morris Daley, had been keeping its books and reporting its income on the completed contract basis for many years prior to the tax year in question. The taxpayers argued below that the Venture was bound to continue the completed contract method of accounting, not having secured the Commissioner's permission to change to the accrual basis. The District Court held that the Venture was a new tax entity, and not bound to follow any previous accounting method. The statement in appellants' refund claims, "The amended returns are consistent with the accounting procedure which was followed by Daley Brothers prior to 1942.", reflects this contention.

American Institute of Accountants, Accounting Research Bulletin No. 45 reads:

"....

"9. The completed-contract method recognizes income only when the contract is completed, or substantially so. Accordingly, costs of contracts in process and current billings are accumulated but there are no interim charges or credits to income other than provision for losses. . . ."

U.S. Treas. Reg. 111, § 29.42-4 (b) (1943) provided:

"Gross income may be reported for the taxable year in which the contract is finally completed and accepted if the taxpayer elects as a consistent practice so to treat such income, provided such method clearly reflects the net income. If this method is adopted there should be deducted from gross income all expenditures during the life of the contract which are properly allocated thereto, taking into consideration any material and supplies charged to the work under the contract but remaining on hand at the time of completion."

Of course, a prime defect in the method is the lack of a periodic reflection of income; many years may pass until net income is determined, depending on the length of the project. See Herwitz, *Accounting for Long-Term Construction Contracts: A Lawyer's Approach*, 70 Harv. L. Rev. 449, 458.

Given a single project, the primary accounts may be kept upon either a cash or accrual basis. It is of little relevance under the completed contract method, for our purposes, whether the expenses are recorded upon payment, or upon the events determining liability; the test is *when* the contract costs are matched against the contract revenue, and a net income or loss figure is struck. Accordingly, in re-

porting taxable income, if it is desired to adopt a completed contract method, if otherwise allowable, the taxpayer will report taxable income from the contract upon the final acceptance of the work. See *E. E. Black, Limited* v. *Alsup*, 9 Cir., 1954, 211 F. 2d 879. *And if the taxpayer reports net income prior to the acceptance of the contract, it is indicative of an election to adopt some method other than completed contract.* Here, the Venture knew the contract was not completed as of December 31, 1942, and reporting of the estimated total contract price of the Delta contract was indicative of the adoption of the accrual method.[3]

Appellants assert that the determinative factor in reporting taxable income is the underlying method of accounting employed in a firm's records, if that method clearly reflects income, and that the Venture kept its records on the completed contract method, and thus was required to report its taxable income on that basis. Section 41 of the Internal Revenue Code of 1939[4] is cited to support the proposition that if the taxpayer regularly employs a method of accounting which clearly reflects income, he must compute his income for tax purposes on the basis of that method.

The accounting method employed on the day-to-day entries may be determinative as to whether the taxpayer has to report taxable income on the cash basis or on an accrual basis, but an election to report on the completed contract basis may be made irrespective of how the primary accounts are kept. We again emphasize that the controlling

[3] Finding of Fact VI of the District Court stated: "In the partnership income tax return for the year 1942, Daley Brothers Delta War Venture reported as income the full contract price of the War Department Contract."

[4] Int. Rev. Code of 1939, § 41, 53 Stat. 24, provided:

"The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; . . ."

point is the time the costs and revenue from the contract are matched, and net income or loss ascertained. Therefore, when the completed contract method is sought to be used, the facts surrounding the election as to when to close the accounts, and ascertain the net income for the period, are controlling. The trial court properly considered the fact that the taxpayers knew the Delta contract was not completed on December 31, 1942, as supporting the conclusion that the taxpayers intended to elect the accrual basis to report taxable income.

Heavy reliance is had by appellants upon testimony concerning the manner in which the underlying accounts were kept. The Venture's accountant testified that he entered the total contract price as a receivable shortly after the contract was obtained, thereby bringing that figure into the income account immediately. Hence, it is argued that under an accrual method, the full contract price would not have been entered as a receivable at the beginning of the work, but only the progress payments would have been accrued as they became payable to the Venture. There are many accounting procedures grouped under the general label "accrual accounting." The fact that the contract price was recorded as a receivable does not necessarily mean the completed contract method was adopted. The essential character of the problem was brought out during the cross-examination of the Venture's accountant, to-wit:

> "Q. Mr. Rosenblatt, I didn't quite understand your explanation of the difference between the accrual basis and the completed contract basis of accounting.
>
> A. Well, the entries to a ledger on an accrual basis are the entries of events as they occur, the entries as to the billing of the accounts for work done, the entries into the books for merchandise or services received as they occur, rather than when they are paid.
>
> Q. You are talking now about what, sir, the accrual method?

A. The accrual method of accounting.

Q. Entries are made when payments are made?

A. No. Entries are made when the events occur irrespective of when payment is made or when it is received.

Q. All right. Now, what is the difference between that and the completed contract basis?

A. *The completed contract basis is a method used with an accrual basis or with a cash basis, in determining profit from the contract.*" (Emphasis supplied.)

We emphasize again that the method of keeping the primary accounts does not compel a report of taxable income on a completed contract basis.

The District Court also based its finding that the Venture intended to adopt an accrual method to report its 1942 income on the fact that John P. Daley submitted to the U.S. Engineer Department on January 26, 1943, a renegotiation form on which he stated that the Venture was reporting its *taxable income* from the Delta contract upon an accrual basis. The form submitted also contained an alternative choice of "completed contract." This admission adds weight to the finding that the Venture adopted the accrual method for tax purposes.

In evidence is a letter from John and Morris Daley, written on December 31, 1942, to William Radtke, during negotiations for settlement of accounts as of that date. The letter states that Radtke's capital account then showed $64,597.77 as his share of the profits. Any ascertainment of profits prior to the completion of the Delta contract would be inconsistent with a completed contract accounting basis.

On the 1942 partnership tax return the box labelled "accrual" was checked for the accounting method employed in making the return; this fact also supports the trial court's findings. It is contended that the label placed on the return is not controlling, citing *Aluminum Castings Co.* v. *Rout-*

zahn, 282 U.S. 92. In that case, the taxpayer's 1916 and 1917 income tax returns stated they had been made on the cash basis, but the taxpayer had computed income on the basis of inventories and accrued receivables and payables. The Court there held that a deduction, accruing in 1916, could not be had on the 1917 return upon the cash basis, since the taxpayer was actually keeping his books on the accrual method. That Court rejected the argument that the label on the return was conclusive, and looked to the substantive method of accounting employed by the taxpayer. It is not contended in the instant case that the label is conclusive, but it is a strong circumstance to be considered.

The trial court found that a portion of the Venture income did not in fact accrue until 1943, although it was reported on the 1942 Venture return. Appellants assert this amount consists of $299,430.73 not yet approved for payment by the contracting officer as of December 31, 1942, and $173,291.42 "holdbacks" from progress payments made in 1942.[5] Under accrual accounting neither item would have been included as income in 1942, and this circumstance is pointed to as indicative of the use of the completed contract method.[6] The trial court drew the inference that the accrual method was improperly applied in the case of the amounts of "holdbacks" and unapproved payments, and that the Venture should have adjusted these amounts to include them as 1943 income: See *Dally* v. *Commissioner*, 20 T.C. 894 (1953), *aff'd*, 227 F. 2d 724, 9 Cir., 1955, *cert. denied*, 351 U.S. 908.

During our consideration of this case, we became concerned with the question of whether the Venture could, in any event, elect the completed contract method of account-

[5] See note 1 supra.

[6] Taxpayers argue in the alternative that the sum of these amounts, $472,722.15, can now be considered as 1943 income under the accrual method, and that a refund is due upon that theory. This contention is discussed later in the opinion.

ing to report income from the Delta contract, in view of the definition of long-term contracts found in U.S. Treas. Regs. 111 § 29.42-4, which provided:

> "Income from long-term contracts is taxable for the period in which the income is determined, such determination depending upon the nature and terms of the particular contract. As used in this section the term 'long-term contracts' means building, installation, or construction contracts *covering a period in excess of one year from the date of execution of the contract to the date on which the contract is finally completed and accepted. . . .*" (Emphasis supplied.)

The stipulated facts disclose that the contract was awarded in July, 1942, and completed and accepted by the United States of America on February 16, 1943, a period of less than one year.

We are now satisfied, however, that the Regulations have not been interpreted to preclude reporting of contracts such as the Delta project on a completed contract basis.[7]

The reasons behind the allowance of the completed contract method make it clear that the intent of the Regulations is to handle the accounting problem arising from the contract extending beyond a fiscal year. Where a construction contract is to begin and end within a single fiscal period, it is of no consequence whether the contract was reported on the accrual or completed contract basis, as the total income or loss from the project would be reported in either case during the same fiscal year. The problem with which the Regulations deal arises when the contract extends

[7] L.A. Wells Const. Co. v. Commissioner, 46 B.T.A. 302 (1942), aff'd, 6 Cir., 1943, 134 F.2d 623, cert. denied, 319 U.S. 771 (1943); Bent v. Commissioner, 19 B.T.A. 181 (1930), aff'd, 9 Cir., 1932, 56 F.2d 99; Jones v. Smith, 10 Cir., 1951, 193 F.2d 381, cert. denied, 343 U.S. 952 (1952); Birkemeier v. Commissioner, 39 B.T.A. 1072 (1939); Anderson-Dougherty-Hargis Co., Inc. v. United States, (N.D. Cal., 1950), 96 F. Supp. 404.

beyond the end of the fiscal year, regardless of the actual duration of the contract, thus posing the question of whether some measure of income should be recognized consistent with the annual accounting concept. The contract with which we are concerned in the instant case, although running less than one year in duration, covered parts of two fiscal years. Hence, the Venture would have been eligible to use the completed contract method, but did not elect to do so.

The finding that the appellants intentionally made their 1942 returns on an accrual basis is affirmed.

Appellants ask us, in the event we find that the Venture is bound by an election of the accrual method, to order a remand of the case for a determination of the amount of refund due them because of an error in the application of the accrual method to the 1942 income return. It is alleged that the sum of $472,722.15 was improperly accrued as 1942 income, which properly should have been included in the 1943 income return. The sum consists of progress payments paid in 1943 under the contract, and also "holdbacks" from progress payments made in 1942, and actually paid in 1943.[8] The trial court found that the items were improperly accrued as 1942 income, but further found that the refund should not be made, because the basis for recovery stated in the refund claims and complaint was upon the ground that the income from the Delta contract was included in 1942 income under an erroneous application of the completed contract method of accounting; and that a proper application of the completed contract basis would shift the contract income to 1943.

> "It is of course the law that a suit for refunds of taxes must be based on a claim previously filed with the Commissioner, and that the claim must set forth in detail each ground on which a refund is claimed and facts

[8] See note 1 supra.